

Global Treasure Hunter: David Winters

For the second issue of *Graham and Doddsville* we are pleased to share an interview with David Winters, Founder and Chief Investment Officer of The Wintergreen Fund. Prior to founding Wintergreen Advisors in 2005, Mr. Winters was Chief Investment Officer of Franklin Mutual Advisors and Portfolio manager of the Franklin Mutual Discovery Fund. Mr. Winters joined Mutual Series in 1987, one year before the death of legendary investor Max Heine. He would spend the next decade working side-by-side with another investing legend Michael Price.

Q: You've described yourself as being on a global treasure hunt. What's the checklist of characteristics that a situation has to have before you invest?

DW: I don't know if there's an exact checklist. There's no magic formula because every situation is a little different. But

if you're talking about what my ideal investment is, first of all I want a good underlying business. A business that is, hopefully, getting better over time, so time is your friend. Then I really need to have management who are committed to doing the right thing, who I sometimes describe as being in the boat pulling the oars in the same direction as the rest of the shareholders.

I think you want to have both those factors plus an undervalued security price.

When you have those 3 things, then you have a trifecta. And you want a trifecta.

Q: Are there additional items that you look at when you're investing in non-US companies? How do you assess things like how solid the currency is, or how reliable the legal systems or the accounting standards are?

DW: They're all good questions, and there are no exact answers. Some countries have wonderful underlying currencies. For example, Norway, where you have all this oil and gas.

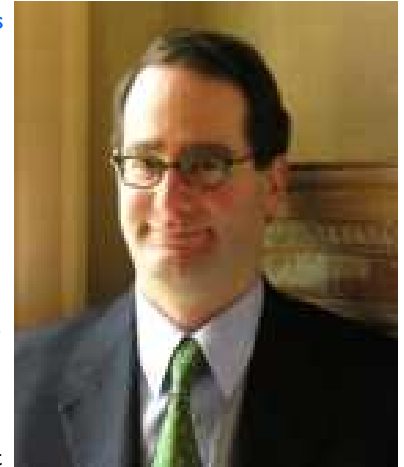
Q: Are there additional items that you look at when you're investing in non-US companies? How do you assess things like how solid the currency is, or

how reliable the legal systems or the accounting standards are?

DW: They're all good questions, and there are no exact answers. Some countries have wonderful underlying currencies. For example, Norway, where you have all this oil and gas. You have 4.5 million people, and you have approximately 300 billion dollars (derived from oil taxes) sitting in a government fund for the betterment of society. So you've got millions of dollars in cash and securities behind every Norwegian citizen. You can see why I think the Norwegian Krona is probably one of the great currencies of the world.

There are other currencies where it's very hard to know. In those situations we might be inclined to hedge out the risk if it made sense. But we like the really hard currencies.

With the legal system you've got to figure out if the rule of law is important to the way the society is run. In a country like Switzerland or the UK, there is rule of law. That doesn't mean there aren't going to be legal surprises, but there are clearly long-standing legal systems to protect owner's rights.



David Winters, Founder and Chief investment Officer of The Wintergreen Fund

Q: You've talked about constructing a portfolio of pearls, where the barnacles on the shells hide the underlying beauty underneath. Where does the search start for you?

DW: The new 52 week low list is a great place to look. And sometimes it isn't just individual names, but a sector may be out of favor. Other times it's complexity that really distorts something that's wonderful, because most people don't like complexity. This business is about people basically being spoon-fed, and if you have a conglomerate that requires a lot of work and more than one sector, that really turns people off.

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We’ve found over the years that in the best investment situations, the more you dig at them the more good stuff you find. And in the bad investments, the more you dig the more you find additional skeletons in the closet (e.g., toxic liabilities that aren’t on the balance sheet).

Often you can figure out pretty quickly if an investment is one where the assets are understated, or is it one where the liabilities are understated. You want lots of assets for free, or the potential for free.

Q: How do you evaluate downside risk in a security?

DW: The ultimate downside risk in a security is permanent loss of your capital. In almost any business other than an asset play, risk and reward are evaluated on the basis of how much cash you can generate over time. You must be aware

of Ben Graham’s margin of safety and look at what the company is really worth. What is the relationship between the company’s worth and its current market price? Does the company have the ability to raise prices? There are many businesses that are so brutally competitive that they don’t have any ability to raise their prices. Then you have to look at what their competitive position is in the world. Do they have an edge? And are they making a product that can be easily duplicated somewhere else, in a fairly undifferentiated manner, at a much lower price. If you’re in a business like that, you’ve got a problem.

The other thing to consider is whether there has been a fundamental change in the underlying economics. For example, for many years the newspaper business was a virtual license to print money. If you owned the newspaper you were one of the richest people in town. Now that is no longer the case because you’ve got classified and display advertising going to the internet. Newspapers have lost pricing power and they’re losing revenue. So I think you really have to pay attention to whether there is a game change, and that’s not always apparent in the valuation or in the annual report.

Q: You’re a long-term investor, but when do you sell?

DW: There are a couple of reasons why you should sell.

One is if you made a mistake. I think one of things we all have to do is to be intellectually honest. Were you wrong in your analysis? Did something change? Or did you learn a new piece of incremental information that changes your view? Instead of being an ostrich about investing, sticking your head in the sand and hoping things improve, often the best thing to do is to realize you’ve made a mistake and to sell.

The other big reason to sell is if the valuation gets out of whack. When you own something wonderful, if it approaches or becomes fully valued, it often makes sense to sell. Even when an investment is great, if it trades at full and fair value, at best it’s dead money. And in all likelihood there is a better use for the money elsewhere. So you have to have the discipline to say, “The company has done its heavy lifting for me. I’ll pay the tax and move on.”

Q: Michael Price visited our class, and he did not have very good things to say about utilizing DCFs. Do you employ them at all?

DW: I probably inherited Michael’s skepticism for DCF. I think of DCF as garbage-in, garbage-out. Conceptually it’s right, but the ability of anybody to make accurate estimates is low. During the many years I worked for him, one of the lessons I learned from Michael was not to be so dependent on

earnings. Wall Street is so obsessed with, “Did they beat by a penny? Did they miss by a penny?” If you’re investing in securities that are so contingent on that, the possibility increases that you’re going to get beat.

Our approach is to try to buy today at a discount and get tomorrow for free. Somebody showed me a DCF model last week and I looked at it and I was pretty skeptical. They had a terminal growth rate of 2%, and I asked, “What happens if it becomes 5%?” The value went up by 100%.

So I share Michael’s skepticism about DCF. I think it’s an over-rated tool. Think about the bubble years, when people were extrapolating things far into the future that ended up being preposterous, while at the same time you could buy real companies like Brown-Forman, that distills Jack Daniels. At the height of the bubble Brown-Forman dropped to a valuation that was probably half of what an arm’s-length transaction would take place at. People were buying DCFs because they wanted get-rich-quick schemes. Brown-Forman had no debt, net cash on the balance sheet and a LIFO reserve. And getting back to Jack Daniels...it holds a place of honor in my heart near the American flag.

Q: What was it like to be a value manager in the late 90’s?

DW: There was a lot of stuff going on. Not only being a value manager, but I was promoted to running Mutual Shares, and basically I came in almost at the bottom of the whole thing.

It was very hard because success demanded being both really disciplined and confident in your work as well as your ability. At the same time you had to realize that the world had sort of taken leave of its senses. There were relatively few of us who maintained the core belief in value investing at the bottom. There was a lady who wrote me a hand written letter complaining that I was a dinosaur, and she said that I didn't get hot investment results because I didn't own Cisco Systems. She wasn't alone in that opinion. There was tremendous pressure from multiple directions to capitulate, and I refused to capitulate. The thing that I found so amazing was that there were wonderful companies you could buy that I had drooled over for years, but could never own because they were always trading at big multiples. So we were able to buy some very compelling things. It wasn't an easy period, but I learned a lot, and it ended up being wildly

profitable for our fund investors.

And there's a lesson in all of this. In February of this year, people were so concerned when we had this sell-off in China one night. "Oh no, China's coming to an end. The sky is falling and the world is coming to an end." Stock markets all round the world went down for a couple of weeks. Everything on TV was negative. There was one day where we were buyers of almost every security we had in the portfolio. And here we are 2 months later, markets have rallied, everything on TV is positive, and nothing's really changed. I think that's really one of the big lessons of value investing, that you've got to do the work, and realize as Ben Graham wrote that Mr. Market is often irrational, and you've got to take advantage of market fluctuation rather than be a victim of it.

But it's hard. You really have to have the right temperament and discipline to do this, and I don't think most people do. It's very hard.

Q: Do you think some people are just born with the right temperament? Has your temperament evolved over time?

DW: I started the David Winters investment account when I was 5, so I definitely had some of the DNA, but I've certainly learned a lot over the years. I've been doing this a long time now, and I try to learn every-

day, watching the way people participate in markets. Part of the reason we set up Wintergreen was so we could try to capitalize on all this stuff that goes on in the world, and not be part of the daily fray.

Q: Do you have any favorite measures of earnings quality?

DW: I like to dissect where a company got its earnings: Was it gains? Was it from operations? I think organic growth is a really important measure. And was organic growth achieved through sales and/or margin?

A lot of this business is based on judgment, and one of the things we've barely touched on is the importance of management. That's one lesson I've learned: the importance of the people you hand your wallet to. Obviously you want a good company you can invest in, or that has good assets, but you also really must have people who are going to make that company work for you.

It's just like if you have a great professor, and you enjoy the class, then you'll get an A.

If you have a professor you don't like, who comes to class and turns his back to the students, then you're not going to do as well.

Q: How do you figure out what makes a management team tick?

DW: The world has gotten in some respects easier and in other respects harder to decipher. You can find out a lot about people today. Not all prior management behavior is a predictor of the future, but you have to figure out if management is motivated to just make a bunch of money and go to the beach, or if they love the business they are in and want to achieve long term success? How do they think? Are they interested in taking short cuts, or are they more interested in taking the longer road and doing things properly?

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Then you’ve also got to try to figure out if the management is risk-averse. We’re very risk-averse here, and we want to do really well, but we don’t want to take a lot of risks to get there.

You also have to try and figure out how people are wired. When you see that certain people must have all the accoutrements of success, and if that becomes an obsession on their part as opposed to living in the same house forever. That is one of the telling signs.

There’s a lot you can learn. It’s not an exact science, but every now and then you have what I call the “ah-ha moment.” Other times you look at it, and you have an “oh-no moment.” You go, “Oh-no, I don’t think so. This is not going to be a situation where we’re going to

be comfortable.” Sometimes there are managements that stay up late at night and try to figure out how they’re going to benefit themselves at the expense of shareholders. Those are the folks you don’t want to be involved with.

Q: Is it harder to try and wrap your arms around the shareholder orientation of non-US managements?

DW: You know I’ve been fortunate since I was a little kid to travel all over the world. I keep having to add pages to my passport.

People and cultures are different, and their behavior is different. One of the things that as an American you have to be very careful about is that everybody doesn’t play by our rules or our expectations, nor do they necessarily respond well to some of our behavior patterns. So sometimes it is very challenging to figure out what’s really going on, but again sometimes you just observe what they do, not what they say. If you see a management team behaving in a rational manner, that’s a really good clue. If you see them doing really bizarre things, or things where you scratch your head and say, “why would they do this,” then it doesn’t matter what they say.

Then occasionally you’ll find a company that is very straightforward and open about what they’re trying to do, and they execute. The thing that’s wild

today is if you think about how many of your colleagues at Columbia are from overseas. Some large percentage of them are going go back to wherever they came from, take all the principles they learned from Columbia, and apply them at home. A lot of those folks are going to kick some serious butt. So part of what we’re finding is that the next generation of managers were educated in the US or the UK, and then they take a lot of the best of the Anglo-Saxon principles and they modify them to fit their own cultures.

I think this is an exciting time in the world, despite all the things we get could obsess about that we know aren’t good. But there are more wonderful things to look at. There is tremendous wealth creation, and you have all this free movement of ideas, and free movement of people. You have all these young people who are doing all kinds of amazing thinking and work all over the planet, so while it is not easy, our view is there are good people in every culture and in every country, and the idea is to just go find those folks. And you just ask around, “Are they good, or are they not good? Are they smart? Are they hard working? Are they honest? Are they nice, or are they not nice?”

Q: How do you recognize, and avoid, value traps?

I’ve been involved in some value traps over the years, and

I’ve learned a lot about their characteristics. There was one that we owned years and years ago where the stock price never went up, and eventually got taken out. You have to try to figure out if the business is any good, and whether the people are any good, but you know if you find something that’s a value trap, time is your enemy. You really want time to be your friend. You want to go to sleep at night knowing that you’re incrementally getting a little wealthier, even if the stock price or the bond price does not reflect it. You have to recognize the impact of time on your investment.

Take HSBC. Though we don’t own it anymore, we loved the idea that somewhere around the world, somebody was going to an ATM, borrowing money, or making an investment. It’s kind of a neat thing to own a piece of a business where 24 hours a day they’re working hard for you. We love those situations.

Q: On a day-to-day basis, how do you filter out the noise?

Part of it is that we’ve really tried to create a very rational, fun, long-term environment. We’ve eliminated a lot of the distractions. We kind of operate as a think tank here. It’s a fun place where there is room for both independence and collaboration of thought, and we do a tremendous amount of reading. There is so much

nonsense outside of the office that we really try to focus on the things where we actually add value by doing research.

There are a tremendous number of things that are unknowable. Think about how much time people spend obsessing about what the next move by the Fed will be. I don't know what it will be, and it really shouldn't matter if you're making good long-term investments. Unless you're doing DCFs where everything is so finely priced, a 25 basis point movement in interest rates shouldn't change your world view. We're just trying to focus on what matters, and to not pay attention to a lot of the nonsense. All we have is time, and once you spend the time it is gone, so we just really try to focus our energy on what we think can make a difference.

It's experience, too, and judgment. Judgment is such an important element in this whole business.

The beauty of the investment business actually is that it's cumulative, and oftentimes the best people in the investment business are not the 22 year-olds who are often the champions in professional sports, but the 72 year olds. As long as they keep learning and they love the business, it's all about thinking and implementing and change. That's why I think it's the greatest business in the world. You can do it forever.

One of my heroes was a guy named Phil Carret, who passed away a couple of years ago. And Phil was over 100 years old when he died, and was just incredible. He was so sharp, and over a full life I think he probably became an even better investor.

Q: We heard you in one of your interviews talk about how you're really focused on building wealth over the next 40 years.

Yeah, it's true! This is fun.

In our view the investment business has gotten bifurcated into an index-hugging model that most of the large complexes are doing. Being overweight or underweight some index by ten basis points is not investing. At the other extreme are highly leveraged compensation models. They capture a large amount of the performance fee carry as fast as possible.

The investment community offers many more choices and ways for people to participate in the market than it did twenty years ago when I was in school. One of the most common is the so-called hedge fund. These investment vehicles offer every imaginable form of diversity, risk and lock ups. With literally thousands of people operating these funds, it stands to reason that there would be a wide range of portfolio managers. I encourage you to carefully research

the reputation and history of those you trust with your money or your career.

All around the world, when we study who's done really well in business, it's taken long periods of time. It most frequently has been done by ownership of pieces or all of a business that have been held for very long periods. It has not been done by hyperactive trading or deals.

And so that's what we're really trying to do, to create long-term wealth without a lot of risk (by risk I mean permanent loss of capital, not quotation risk), and to be in a position so that when people do panic, which they seem to do once every three months or so, that we're there to pick up the pieces.

Cash is great, we love cash. And today you get paid 5% to hold onto cash while you wait for the investment you want to be available at the price you like. Cash is a beautiful thing, not only us having cash, but we love companies that have cash. Because as long as they have the right management they can be opportunistic on buying back stock, doing deals, paying dividends, etc. Increasing amounts of free cash flow is a wonderful thing.

I have a friend of mine named Andrew, he's been a friend of mine since I've been a kid. And I started managing Andrew's money years ago, and it was a relatively small pile. It's a much

bigger pile now, thankfully, and Andrew's attitude is that he looks at his statement twice a year, and generally if there's more than there was the last time he looked at the state-

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ment, he's happy. Part of the reason we did a mutual fund, even though our whole generation went in the opposite direction, is that the mutual fund business is being dominated by this index-hugging model, which we don't buy into, and the public in general doesn't know what to do with its money.

And we set it up so that our money is side by side with our investors. My business partner Liz Coehornour and I started out basically with all friends and family, now it's extended friends and family, but you know whether it be my parents or my friends, many of them don't know what to do with their money, and they don't really want to obsess about it either. They want to put it somewhere, where it will be more when they need it. That's what we do, and then we try to write to everybody twice a year and explain what we're up to. In the last letter we used Mark Twain quotes to try to explain that human nature hasn't changed very much over the years.

Q: What is the market missing on Japan Tobacco?

DW: JT is a very complicated company. It's a Japanese company and they're doing a great job. They've just closed on buying Gallaher in the UK, and we think it's a very, very smart acquisition. They had 6 billion dollars in cash, give or take, earning 1%, and by doing this

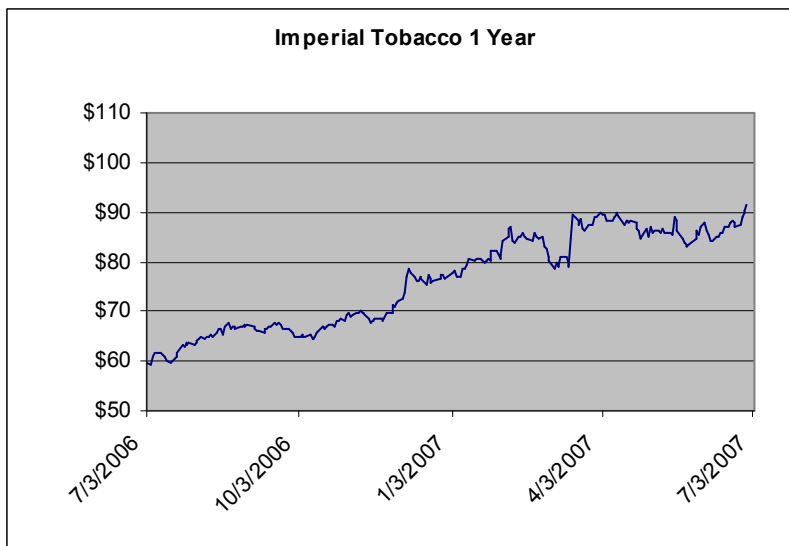
deal they not only increased the size of the company, I think their cost of financing, pre-tax, is going to be 3 and a half percent. It's very lucrative.

We don't advocate smoking, but we do think the economics of the business are good.

Q: Can you talk about Imperial Tobacco, and the management there?

DW: Imperial is an amazing company. The Imperial Tobacco management, as we put in our last annual report shareholder letter, is we think one of the best managed companies in the world. They came out of Hanson. Lord White and Lord Hanson built a conglomerate in the '60s, and it was dismantled in the '90s. Hanson was always a very cost conscious, high integrity kind of a place.

Imperial comes out of that culture. They have the largest market share in the UK, and they've done a series of very smart acquisitions. They've bought back stock; they've issued stock when they needed to. They're just great capital allocators, and they never let



Imperial Tobacco Group plc (ITY- NYSE)

Price: 91.93 (7/19/06)
52 Week Range: 61.16 - 92.93

Market Cap: 31.01 billion
Sector: Consumer Goods

all of this go to their heads. They're really pretty humble people, yet they have one of the best records of any corporate management I've ever seen. We're Imperial fans.

Q: What's the best investment that you've ever made, and did you realize the upside at the time of purchase?

DW: One of the best ones has to be Berkshire Hathaway. It's just been such a great long-term investment. One of the things that's neat about Berkshire is that it has become a better company than it was.

The annual reports are great because they make you think. That's not only been an excellent financial investment, but it's been a great intellectual investment. Berkshire has provided not only direct finan-

cial benefits, but there have been ancillary benefits because studying that company has improved how I think.

Q: Almost every investor who comes to speak on campus extols the benefits of concentration. They're all very successful, though it's interesting that they define a concentrated portfolio differently. For some it's 4 or 5 stocks, for others it's 50 or 60. You have about 30 positions. Why does that number sit right with you?

DW: We're a mutual fund, regulated by the Investment Company Act of 1940. Therefore it has to be diversified and meet certain specific diversification requirements. Most of the guys who are running 4 or 5 stocks are in a partnership format, and usually are getting annual fees of 1 or 2 percent

plus 20% of the profit. We have a partnership that's got the same management fee as the mutual fund. It is more concentrated, so it will have a lumpier performance, but it is not as small as 4 securities or 5 securities.

I think that if you can find 4 or 5 great investments and ride them, it's probably going to be a lumpier way to investment nirvana, but it works. For us, we have a couple of very large positions. We call our investments the major leagues, the minor leagues, and the farm team. Some of them are on their way up, some are on their way down, and some of them you just couldn't get enough of because it was not available at the price you want to pay.

I think you want to be diversified on some level, in case a satellite hits the company, or something terrible happens that you don't expect. But the more you can have in your highest conviction ideas, as long as you've done the work, in all likelihood you'll have better results. We don't want to run Noah's Ark (2 of everything). I've seen that, and you might as well go buy an ETF or an index fund. We're comfortable somewhere in between. We don't want to put it all on black with leverage. That's not our style.

We also want to be in a position where if there's an unexpected event, that we can react to it. I'll give you an example.

In 2002 there was a series of corporate scandals. Enron, Adelphia, and all this stuff happened. There was a gap downward in the high yield market, and then there was another very sickening drop, because after the initial scandals there were a whole series of other ones. So for what now, in retrospect, looks like a very short period of time, it was almost complete disarray in the fixed income market. But if you didn't have the money, you wouldn't have been able to buy all this great debt cheaply. So we don't agree with the idea of always being fully invested, and that every great idea is always going to be apparent at that time.

One of things about this business is that sometimes you just have to be patient and wait for the fat pitch. Going back to the bubble period, the bubble went on for quite sometime, and it was really almost at the end of the bubble where people were just capitulating for get-rich-quick schemes. They couldn't stand the fact that their neighbors were getting rich in zippidy-do-da.com, and they would sell the Brown Forman. In retrospect many people now realize they were following a fad rather than true style.

Q: What advice would you give MBA students?

DW: Just be true to yourself, and try to find something that you love. I think that so many people get obsessed with trying

to do what they think will get them to a certain point, but if you enjoy the passage of time, the likelihood that you're going to be happy, healthy, and successful increases.

You've got to find something you're passionate about, that really makes you want to go the extra mile, because often times that's what differentiates success in business. Sometimes it's just luck, like the Beverly Hillbillies where you miss the turkey and you hit the oil well, but a lot of it is just that you're so excited about how you work and what you do that you can't wait to do that extra little incremental thing. That has got to come from love, not greed. Most of the people that are really, really successful, I don't think it was only money that motivated them.

Thank you Mr. Winters.

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